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No. 77-1124

In the Supreme Court of the United States

OCTOBER TERM, 1977

SOUTHWESTERN LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the district court (Pet. App. B, pp. B-1 to B-54) is not officially reported. The opinion of the court of appeals (Pet. App. A, pp. A-1 to A-53) is reported at 560 F. 2d 627.

JURISDICTION

The judgment of the court of appeals was entered on October 5, 1977. A petition for rehearing filed by petitioner was denied on December 2, 1977. The petition for a writ of certiorari was filed on February 10, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals correctly held that payments made by petitioner with respect to insurance contracts it issued to various pension and profit-sharing plans, and characterized by it as "excess interest," did not qualify as "amounts in the nature of interest" within the meaning of Section 805(e)(2) of the Internal Revenue Code of 1954.

Section 805(e)(2) of the Internal Revenue Code of 1954 (26 U.S.C.) provides:

> SECTION 805 [as amended by Section 2(a), Life Insurance Company Income Tax Act of 1959, 73 Stat. 120]. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.
>
> * * * * *
>
> (e) *Interest Paid.*—For purposes of this part, the interest paid for any taxable year is the sum of—
>
> * * * * *
>
> (2) *Amounts in the nature of interest.*—All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.
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> * * * * *

STATEMENT

Petitioner is a life insurance company which issues various types of insurance contracts, including certain specialized annuity and life insurance contracts designed for pension and profit-sharing plans. The pension trust

annuity contracts generally provided for specified monthly payments upon a participant's retirement or attainment of age 65, and for payment of death benefits prior to such time in the amount of the cash surrender value of the policy. The pension trust life contracts provided for the payment of specified additional death benefits to plan participants. Petitioner maintains life insurance reserves with respect to both types of contracts (Pet. App. A, pp. A-25 to A-26).

Under state law, the maximum interest rate petitioner could use in computing these reserves is 3 1/2 percent. In order to compete more effectively with banks and other financial institutions that administer pension plans, petitioner agreed to pay the plans that purchased its contracts an annual amount, which it characterized as "excess interest." Petitioner agreed to pay this additional amount when its actual earnings rate exceeded the 3 1/2 percent assumed interest rate used in computing the reserves. The amount of this "excess interest" is computed on the basis of a "new money rate" formula which reflects petitioner's return (with certain adjustments) on funds invested by it during the year (Pet. App. A, pp. A-25 to A-26).

On its income tax returns for the years in issue, petitioner treated its "excess interest" payments as "amounts in the nature of interest" under Section 805(e)(2) of the Code, which had the effect of increasing the portion of its net investment income excluded from its "taxable investment income" under Section 804(a)(1) as the "policyholders' share" of such income. On audit, the Commissioner determined that petitioner's "excess interest" payments did not qualify as amounts in the nature of interest as that term is defined in Section 805(e)(2). The Commissioner's position rested on the fact that the

contracts in question involved life contingencies and Section 805(e)(2) applies only to payments with respect to contracts "which do not involve, at the time of accrual, life, health, or accident contingencies" (Pet. App. B, p. B-19).[1]

In this refund suit in the United States District Court for the Northern District of Texas, the court held that petitioner's "excess interest" payments were "amounts in the nature of interest" under Section 805(e)(2). In that court's view, all that was required for a payment to qualify under Section 805(e)(2) is that the "amounts" of such payments "do not involve, at the time of accrual, life, health, or accident contingencies," without regard to whether the contracts themselves involve such contingencies (Pet. App. B, pp. B-43 to B-44).

The court of appeals reversed. It concluded that the statutory phrase "which do not involve, at the time of accrual, life, health, or accident contingencies" refers to the term "contracts" and not the term "amounts." Since there was no dispute that the contracts in question were subject to such contingencies, the court of appeals held that the excess interest payments failed to qualify as "amounts in the nature of interest" under Section 805(e)(2) (Pet. App. A, pp. A-25 to A-31).

ARGUMENT

1. In this life insurance company income tax case of first impression, the court of appeals correctly held that petitioner's payments of amounts characterized as "excess

[1]The Commissioner allowed the "excess interest" payments to be treated as "dividends to policyholders," deductible in the computation of petitioner's "gain from operations" under Section 809(d)(3), subject to the limitations provided by Section 809(f).

interest" did not qualify as "amounts in the nature of interest" under Section 805(e)(2) of the Code. As a result, petitioner could not take these payments into account in computing the exclusion for the "policyholders' share" of its net investment income. See Section 804.

Section 805(e) defines "interest paid" by a life insurance company as the sum of four elements, including "amounts in the nature of interest" (Section 805(e)(2)). The statute defines that term as "[a]ll amounts in the nature of interest, * * * on insurance or annuity contracts * * * *which do not involve, at the time of accrual, life, health, or accident contingencies*" (emphasis supplied).

Petitioner did not dispute in the courts below that the annuity and life contracts it issued to the pension plans involved "life, health, or accident contingencies." However, it argued that the final statutory phrase—"which do not involve, at the time of accrual, life, health, or accident contingencies"—modified the word "amounts" and not the term "insurance or annuity contracts," as the government urged.

But as the court of appeals pointed out (Pet. App. A, pp. A-30 to A-31), petitioner's construction of the statute—"all amounts * * * which do not involve * * * contingencies"—makes little sense, since an "amount" cannot "involve, at the time of accrual, life, health, or accident contingencies." As the court observed, for petitioner's construction to have any meaning, the statute would have to read as "all amounts whose computation does not * * * [etc.]." That is not what Congress said, however, and there is no basis for petitioner's gloss upon the statute.

On the other hand, the government's reading of the statute "has a complete meaning as written" (Pet. App. A, p. A-30), *viz.*, "[a]ll amounts in the nature of interest

* * * on insurance or annuity contracts * * * which do not involve, at the time of accrual, * * * contingencies." Since petitioner did not dispute that its annuity contracts involved such contingencies, the court of appeals properly concluded that petitioner's "excess interest" payments did not qualify under Section 805(e)(2).[2]

Moreover, the concept of contracts which do or do not involve life or accident contingencies is a familiar one in life insurance company taxation. For example, Section 801(b)(1)(B) defines the term life insurance reserves as "amounts * * * which are set aside to mature or liquidate, * * * future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts * * * *involving* * * * *life, health, or accident contingencies*" (emphasis supplied). There is no doubt that the final phrase in Section 801(b) modifies the word "contracts" and not "amounts." See Treasury Regulations on Income Tax, Section 1.801-4(d) and (e) (26 C.F.R.).

Finally, the distinction drawn by Section 805(e)(2) between amounts in the nature of interest on contracts that involve contingencies and such amounts on contracts that do not is consistent with the statutory scheme of life insurance taxation. With respect to contracts that involve life contingencies, the reserves will qualify as "life insurance reserves" and the company's earnings from its reserves will be taken into account in determining the exclusion of the policyholders' share of the company's investment yield under Section 805(a)(1) or (a)(2). Thus, as the court of appeals correctly recognized (Pet. App. A,

[2]Section 805(e)(2) was first enacted into law in the Revenue Act of 1942 as Section 201(c)(6)(B) of the 1939 Code. Although the Committee Reports do not address the specific question at issue here, the Senate Report indicates that the phrase under consideration refers to "contracts" and not to "amounts." S. Rep. No. 1631, 77th Cong., 2d Sess. 146 (1942). See also Nash, *Federal Taxation of Life Insurance Companies*, Vol. 1, §6.04[2], p. 6-37 (1977).

pp. A-30 to A-31), petitioner's construction of Section 805(e)(2), under which its "excess interest" payments would be taken into account in determining the policyholders' share of investment income, would result in a double exclusion for all or a substantial portion of its earnings on its pension plan reserves.

Under Section 805(a)(2), petitioner is entitled to exclude its current earnings on its pension plan reserves. The "excess interest" payments for which petitioner seeks an exclusion under Section 805(a)(3) are also based on its earnings on its pension plan reserves. Since its earnings on such reserves already have been excluded from taxation under Section 805(a)(2), the court of appeals properly refused to permit petitioner to exclude them a second time under Section 805(a)(3).[3] See also Section 818(e).

2. Petitioner alternatively argues (Pet. 25-27) that even assuming the correctness of the court of appeals' interpretation of Section 805(e)(2), its "excess interest" payments qualify under the statute because its contracts did not involve life or accident contingencies at the time it accrued the payments. The annuity contracts involved life contingencies from their inception and not merely at their maturity date. Indeed, petitioner's own actuary so testified in the district court (R. 250-251).[4]

[3]The exclusion for pension plan earnings provided in Section 805(a)(2) is limited to the "current earnings rate." Thus, the exclusion would not encompass petitioner's excess interest payments to the extent those payments were based on a "new money rate" in excess of "current earnings rate." Nevertheless, as petitioner concedes (Pet. 18-19), adoption of its position would in all events result in a double exclusion for a substantial portion of its pension plan reserves, and when the company's "current earnings rate" approached the "new money rate," there would be a double exclusion of the entire amount of its excess interest payments.

[4]"R." refers to the record appendix filed in the court of appeals.

Moreover, if petitioner's annuity contracts are not considered as involving such contingencies prior to maturity, it would follow that the reserves on such policies would not qualify as "life insurance reserves" under Section 801(b). The fact that a participant might withdraw the cash surrender value before payment of the annuity benefit begins provides no more basis for holding that payments under such contracts prior to that time are "amounts in the nature of interest" under Section 805(e)(2), than it would for holding that the reserves for such contracts are not "life insurance reserves" under Section 801(b).[5]

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[5]Finally, petitioner complains (Pet. 14-18) that the decision below puts life insurance companies at a competitive disadvantage with respect to banks and other financial institutions which administer pension trusts. But it can hardly be seriously claimed that insurance companies are unfairly taxed in relation to such other types of financial institutions. Indeed, Congress permits a life insurance company to exclude the entire amount of its current earnings on its pension plan reserves from taxation, even though only a part of those earnings might actually "belong" to the policyholders.

Petitioner also suggests (Pet. 17-18, 26-27) that certiorari should be granted in order to stem the "substantial litigation" it suggests this decision will provoke. But the question presented in this case is of first impression. Despite in fact that the 1959 Act has now been in effect for almost 20 years, this is the only decided case on this point.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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